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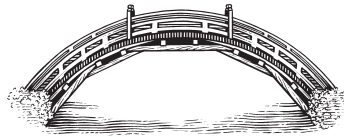
POLICY Q&A

Understanding Islamic Finance: Local Innovation and Global Integration

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What is Islamic finance (IF)? Islamic finance has recorded dramatic growth over the last decade or so, with a presence in more than 75 Muslim and non-Muslim countries and total financial assets now estimated to exceed $1 trillion. With the integration of IF and Islamic banking into the global economy, IF's appeal as a market for and source of global capital is increasing. The industry's rapid growth is marked by increases in Islamic financial products and services, the development of the industry's regulatory frameworks, and enhanced international linkages.

At the same time IF's growth and integration into the global economy has raised concerns among both Muslims and non-Muslims. Debates among Muslim financiers continue over the application of *sharia* (Islamic law) in a financial context. Others question whether IF is ultimately being leveraged to fund Islamic terrorism throughout the world.

To gain a better understanding of the phenomenal rise of IF in general, of Southeast Asia's particular role as an epicenter for IF innovation and development, and of the opportunities and challenges facing IF as an economically viable global financial industry, *Asia Policy* presents insights from a panel of senior finance officials, industry practitioners, and scholars.[1]

This policy Q&A is divided into four sections:

[1] On October 18, 2007, the National Bureau of Asian Research (NBR) convened a conference, under the direction of Senior Project Director Mercy Kuo, to explore the growth of Islamic finance (IF) in Southeast Asia, which is considered a leading center of innovation and expertise in IF. Islamic finance experts assembled both to discuss the institutions, beliefs, and trends fueling the industry's evolution and to consider ways for shaping the context in which these developments are unfolding. This policy Q&A is an adaptation, with the assistance of Torrey Goad and Nualchan Sakchalathorn, of the essays that participants presented at the conference.

WHAT IS ISLAMIC FINANCE?

AP: *Islamic finance is one of the fastest growing sectors in the international financial system. For many, the meaning of "Islamic finance" is unclear. What exactly is IF?*

Ibrahim Warde: Islamic finance arose when Islamic jurisprudents reinterpreted a rich legal, but pre-capitalist, tradition to suit the requirements of the modern era. Islamic banks were to avoid interest (*riba*) and to focus instead on partnership finance (*mudaraba*) or profit-and-loss-sharing (*musharaka*). This new approach to finance was to be at once authentic, since it was rooted in the ancient Islamic way of financing trading caravans, and modern, since it resembled venture capitalism. By focusing on cash-poor but promising entrepreneurs, partnership finance held more economic potential than conventional, collateral-based lending, which favors established businesses. Another distinctive feature of Islamic banking was to be its focus on developmental and social goals.

Shamshad Akhtar: It is important to recognize that IF confines itself to largely social and development projects and that institutions are not permitted to invest in prohibited or socially undesirable investments. An emphasis on ethical issues and rigorous self-regulation in terms of sharia supervision ensures fair play and justice and offers a superior consumer protection model. Furthermore IF induces higher financial discipline and places stringent ethical standards on all stakeholders, offering a strong and unique model of governance.

AP: *How can one succinctly distinguish between conventional finance and IF?*

Akhtar: The main enforcement of contracts and rules-compliance in the Islamic system is ideology and faith, which are in turn influenced by Islam's emphasis on establishing an ethical and fair socio-economic system. It is this feature that distinguishes Islamic from conventional finance.

What also distinguishes IF is its emphasis on the trading of goods and services and its advocacy for profit- and risk-sharing in businesses supported by a variety of partnership arrangements. This stands in sharp contrast to the loan-based financing of conventional banks. By virtue of these characteristics, IF offers prudent financing options being asset-backed or equity-based. Concurrently IF offers promising potential for providing all segments of the population with alternate avenues for saving and investment.

Zeti Akhtar Aziz: The intrinsic nature of IF encourages risk management and provides confidence through the explicit disclosure and transparency of the roles and responsibilities defined in the contract. In IF strategies to minimize and manage risk involve integrating such risk into real activities. These activities thus need to generate sufficient wealth to compensate for such risks. In contrast, conventional instruments generally separate risk from the underlying assets. As a result, risk management and wealth creation may, at times, move in different or opposite directions. Conventional financial instruments also allow for the commoditization of risk, leading to its proliferation through multiple layers of leveraging and disproportionate distribution. This could result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth.

AP: *Must one financial option—either conventional or Islamic—exclude the other?*

Robert W. Hefner: One of the most widespread causes for concern on the part of governing elites in several Muslim countries is that the designation of one part of the financial sector as "Islamic" might discredit financial institutions operating according to conventional, interest-charging principles. Leaders in most countries, however, feel that the continued operation of conventional banking is justifiable on grounds of the "public interest," a widely accepted principle of action in Islamic jurisprudence known by the term *maslaha*.

Akhtar: While the current hype in industry may be partially driven by availability of surpluses generated by oil revenues, Islamic banking is emerging as an alternative financing option that coexists alongside the conventional financial industry. Moving from traditional Islamic products, the industry is now also offering consumer financing for residential purposes and structuring financing vehicles in support of infrastructure and housing finance projects, among others.

AP: *What is the public's role in Islamic financial policy in Muslim-majority countries?*

Hefner: The acceptance of conventional banking on the grounds of public welfare remains the guiding principle of policy in the great majority of Muslim countries today. The two broad exceptions to this generalization are: first, countries such as Pakistan, Iran, and Sudan that have used the power of the state to do away with conventional finance entirely; and, second, countries

such as Libya, Morocco, and Syria that proscribe IF. With the notable exception of these examples at the margins, most governments in Muslim-majority countries have over the past two decades moved toward a pragmatic financial pluralism characterized by the coexistence of financial institutions based on both Islamic and conventional finance.

Frank E. Vogel: The Muslim public has always played a central role in the Islamic legal system. The public's problems, customs, support, and willingness to accept offered solutions has always had a formative role in *fiqh*'s (Islamic jurisprudence) content. The public determined ultimately who among scholars had the most influence and prestige. Here questions arise as to whether the elites in IF—investors, practitioners, legal scholars, theoreticians, and regulators—each group with its own perspective, will trust the Muslim public to decide the future of IF and will empower them through increasing education and transparency. But the elites worry: will the popular "market," both commercial and religious, sufficiently protect Islamic legitimacy and prevent abuses, as understood by these elites?

AP: *What is the current status of IF as a global financial system?*

Zeti: With an estimated average annual growth of 15% to 20% IF is now among the fastest growing financial segments in the international financial system. As recently as five years ago IF was regarded as an infant industry striving to prove its viability and competitiveness. In these five years IF has recorded dramatic growth, having a presence now in more than 75 countries both in Muslim and non-Muslim dominated communities. A growing number of international financial centers—such as London, Singapore, and Hong Kong—are beginning to offer Islamic financial products and services. The number of Islamic banking institutions worldwide, including conventional banks that are offering Islamic banking services, has doubled to more than 300. The total value of Islamic financial assets under their management is now estimated to exceed $1 trillion, about fivefold the magnitude of five years ago.

THE HISTORICAL DEVELOPMENT OF ISLAMIC FINANCE: THE ARAB AND MALAYSIAN MODELS

AP: *What are the historical origins of modern IF?*

Warde: Modern IF—by and large a creation of the Arab world—appeared in the early 1970s at the intersection of two important developments in the Islamic world: the rise of pan-Islamism under the aegis of Saudi Arabia and the oil boom of 1973–74. With the creation in 1970 of the Organization of the Islamic Countries (OIC), the idea of updating traditional Islamic banking principles was soon on the agenda. Research institutes focusing on Islamic economics and finance sprouted throughout the Islamic world. The quadrupling of oil prices turned many Islamic countries into financial powerhouses and favored a mood of experimentation and assertiveness.

The intergovernmental Islamic Development Bank (IDB), which was to become IF's cornerstone, was created at the 1974 OIC summit in Lahore. In 1975 the Dubai Islamic Bank—the first modern, non-governmental Islamic bank—came into existence. Over the next few years Islamic financial institutions appeared in Egypt, Sudan, Kuwait, Bahrain, and Jordan. A significant geographic broadening occurred in 1979 when Pakistan became the first country to embark on a full Islamization of its banking sector. Sudan and Iran did the same in 1982 and 1983, respectively.

AP: *How did this initial experiment with IF fare? What were some of the key factors behind IF's initial success or failure?*

Warde: The experience of the first Islamic banks proved quite disappointing. Some of the reasons had to do with macro-economic factors such as the decline of oil prices after 1981. There were, however, also structural flaws that raised questions over the very model of partnership finance. The preoccupation with real or physical assets led to a preference for investments in commodity markets and real estate—both quite speculative endeavors that contributed little to economic productivity.

Islamic finance was thus often dismissed as a passing fad associated with the oil boom. In reality, IF was on the cusp of a major boom, albeit after adjusting in fundamental fashion to new circumstances. The early disappointments gave rise to a new *ijtihad* (re-interpretation of Islamic law), characterized by greater realism. Deregulation and technological change modified international finance, while political, economic, and demographic forces—e.g., the collapse of the Soviet Union, the advent of globalization, a

changing oil market, the rise of Asian "tigers," a growing Islamic presence in the West, and the emergence of new Islamic middle classes—had transformed the Islamic world.

More pragmatic approaches gained ground. The new world of finance—characterized by the blurring of distinctions between commercial banking and other areas of finance, financial innovation, and the downgrading of interest income—allowed IF to thrive.

AP: *Many specialists note the rising significance of IF in Southeast Asia—particularly in Malaysia—as the center for IF innovation and growth. Please compare the "Arab" and "Malaysian" models of IF, which were born from very different historical circumstances and drivers.*

Warde: In general the Arab ijtihad was concerned with asset management while the Malaysian model focused on generating sources of financing for the economy. More broadly differences in religious traditions and political-economic contexts resulted in divergent interpretations and practices. Another fundamental difference between the two systems is that the Arab model evolved in a somewhat haphazard fashion whereas the Malaysian model was clearly based on a directive, top-down approach. Whereas the sharia-guided Arab model was fragmented and decentralized, Malaysia sought consistency by centralizing the process at its Central Bank.

AP: *Considering these different approaches to IF, what factors guide the growing synergy and integration of IF between Southeast Asia and the Middle East?*

Warde: The growing integration of Arab and Malaysian IF can be traced to the direct and indirect consequences of the September 11 attacks. Until then, the main players pursued go-it-alone strategies. Crucial developments were the freezing of the assets of prominent Saudis and the crackdown on Islamic financial institutions and charities following the attacks, moves that led many Muslim investors to take a significant chunk of their assets out of the United States. Home markets could not absorb all those withdrawals (estimated at about $200 billion) and the quest for a new diversification strategy led more or less naturally to Malaysia, a Muslim country that had achieved an impressive level of economic development.

Earlier misgivings over diverging interpretations of the sharia gave way to a quest for common ground. It should be noted that Arab-Malaysian integration is part of the broader phenomenon of the regionalization of IF.

AP: *To build on these observations, trends in IF's global expansion suggest an increasing linkage between countries of the Muslim world, Asia, and the West. Governor Zeti, you have related these trends to the emergence of a new Silk Road. Can you please elaborate on this comment?*

Zeti: Islamic finance is now at the threshold of a new era in which it will potentially play an increased role in strengthening international financial linkages between nations. Islamic finance has the potential to contribute to the efficient mobilization and allocation of funds across regions. IF not only has a potential role in strengthening integration and linkages within Asia but also more importantly in forging linkages with other dynamic emerging regions such as the Middle East.

Several economies within Asia are now beginning to participate in these trends, thus further strengthening economic and financial linkages between these two dynamic growth regions. These enhanced inter-regional linkages between Asia and the Middle East have created a new Silk Road on which financial services providers across continents now operate.

THE ECONOMIC SUSTAINABILITY OF ISLAMIC FINANCE

AP: *We have looked at IF's historical growth. What are some of the key challenges facing IF's future and economic sustainability?*

Akhtar: Islamic finance should be recognized as a parallel system that will augment and be augmented by the deeper knowledge and experience of the conventional financial system. As such the key challenge to its growth and sustainability lies in how IF interfaces with—and benefits from complementing and supplementing—the conventional system.

Hefner: As Governor Akhtar has observed, the key to IF's growth is not piety alone but coalition building and entrepreneurial dynamism. The key lies, and will continue to lie, in the ability of the proponents of Islamic banking to build a broad coalition with other actors in state and society in such a manner that the growth of Islamic institutions is seen as bringing widespread social benefit rather than, say, threatening already-established economic institutions.

The growth of Islamic financial institutions will continue to be the most rapid where these Islamic institutions focus on developing a diverse array of instruments to provide new opportunities and services.

The key to the continuing growth of Islamic financial systems is thus the recognition that, in the complex world in which we live, the advantage goes to players who show an aptitude for creating positive synergies across systems and civilizations instead of assuming that social and economic pluralism invites a "clash of civilizations."

AP: *In what ways has IF in Malaysia and elsewhere proven innovative and adaptive, developing sharia-compliant instruments that provide new opportunities and services?*

Warde: An Islamic financial system that could offer a growing array of sophisticated financial services was part and parcel of the effort to turn Kuala Lumpur into a leading regional, if not international, financial center. Unlike countries engaged in the wholesale Islamization of their banking sectors, Malaysia opted for a dual banking structure whereby an Islamic sector would coexist with the conventional one. This approach was consistent with the view that Islam could be harnessed to achieve the goal of economic growth through the embrace of high technology and finance.

The *ulema* (Islamic scholars) in Malaysia were challenged to a new ijtihad, a more innovative approach exploring the wide array of sharia concepts that had not even been tested. They were also encouraged to look at the state-of-the-art in global finance and create corresponding Islamic products. The only products to be excluded were those that explicitly challenged Islamic beliefs.

Malaysia was the first country to introduce Islamic mortgage bonds based on the principle of profit-sharing. Malaysian banks also pioneered the use of Islamic credit cards. More recently Malaysian banks pioneered the use of certain Islamic derivatives, such as the profit-rate swap, conceived as a sharia-compliant substitute for an interest-rate swap.

Another singular characteristic of the Malaysian system is that Islamic products are geared to Muslims as well as to non-Muslims. Muslims have the opportunity to invest according to their religious beliefs, while non-Muslims—especially the Chinese minority, which controls most of the country's wealth—have an extension of choice in money management.

Nik Norzrul Thani: Except for Malaysia, which has put in place extensive regulatory framework and infrastructural support for IF to co-exist with its conventional counterpart, other countries are still at the stage of "arranging the bricks." Malaysia has gone as far as to include a vision for IF under its ten-year master plan for the financial sector, has set up a Malaysian Deposit Insurance Corporation able to cover IF institutions through sharia-compliant policies,

and has even set up a RM500 million fund to develop human capital for the industry through the International Center for Education in Islamic Finance (INCEIF). Other countries, by contrast, are still at the stage of ensuring a neutral tax treatment that does not put IF products at a disadvantage compared to conventional products. On this basis alone, it is reasonable for investors to be extra cautious while evaluating the cost-benefits of IF for the rest of the region.

AP: *What role could Southeast Asia as a region play in insuring the economic viability of IF?*

Thani: Southeast Asia should be regarded as the epicenter of development and innovations that contribute enormously to the overall acceptance of IF into the mainstream of global finance. Historically Southeast Asia has contained the important maritime routes for trade between the East and the West. Today Southeast Asia continues to be one of the world's most dynamic regions. Since the turn of this century Southeast Asia's economies are among the fastest growing in the global economy. Southeast Asia's steadfast reform and restructuring efforts have rewarded the region with strengthened macroeconomic fundamentals as well as with sound and stable financial systems.

Having relative political stability and a sound market economy enables Southeast Asia to continue welcoming an increasing number of players in the region. Competition for the Southeast Asian market is very keen and strong, reflecting a vibrant and open market economy. Many players also consider it strategic to use their presence in Southeast Asia as a stepping stone to expand into other markets, including the Indian subcontinent, Far East, and Australasia.

AP: *Looking ahead, what are some of the key steps required for IF to sustain long-term growth?*

Zeti: Three key elements will be important in sustaining the current momentum: investing in research and development, leveraging information technology (IT), and developing human capital with expertise in Islamic law and experience in international finance.

As IF continues its robust international expansion, an adequate supply of talent and expertise is vital to support the growth. Successful Islamic financial institutions will be those that are able to exploit IT's full potential

and opportunities. By embracing new technology, the potential for the Islamic financial industry to provide new products and services will be enhanced.

Akhtar: Prospects for this industry appear comforting because of a variety of factors, the most significant of which being the strengths of Islamic ideology and an economic system that offers a complete framework for the IF industry. An Islamic financial system sets down rules of conduct and contractual arrangements and offers a feasible financing structure emphasizing trade and equity financing that together will foster much needed financial diversification in Islamic countries.

The emerging solutions to structure IF innovatively have helped cater to all types of markets and financing requirements, ranging from retail to both project and home financing to equity funds, products, and insurance. Industry efforts to benchmark pricing and apply legal, regulatory service standards at par with conventional products and standards have also encouraged confidence in the system.

Going forward, the sustainability of IF will rest in how the international community builds on the momentum achieved thus far. This would require:

- further deepening efforts to enhance the legal and regulatory framework of IF consistent with international practices
- recognizing that IF has perpetuated and changed the dynamics of cross-border private capital flows, and that this industry has great potential to augment the process of globalization and financial integration, but that this requires more cooperation and vigilance on the part of home and host regulators
- launching aggressive efforts to implement evolving Islamic financial regulatory and supervisory standards and to capture the different types of risks associated with IF while launching consumer protection frameworks

CHALLENGES FACING ISLAMIC FINANCE: MANAGING PRACTICES, PRODUCTS, AND PERCEPTIONS

AP: *We have discussed some of the key challenges facing IF as a competitive alternative financial system. What is the potential impact of IF's growth and innovations on the global financial system?*

Hefner: As the field of IF has grown, scholars and practitioners have had to adapt their ideas and practices to the sobering challenge of market competition and efficiency. In doing so, they have needed to shift from some of their earlier ideas as to how IF should be conducted and instead develop instruments that significantly diminish the gap between conventional and Islamic finance. This in turn has led some Muslims to question whether the difference between Islamic and conventional finance is as great as the first generation of proponents of IF had imagined.

Vogel: Along these lines the current debates over religious justification and authority in IF reveal underlying strains that may surface wherever Muslims strive to revive sharia while understanding sharia chiefly as the textbook rules of the fiqh of the past. Key opinion-makers in IF—religious-law scholars (*fuqaha*), leading theoreticians of IF and economics ("Islamic economists"), and important industry practitioners ("Islamic bankers")—carry on these debates with the conviction that they are crucial to the future of the industry.

As we've been discussing, new developments in transaction design have surfaced that further force the issue. With these flexible, multi-use innovations, which provide ever-cleverer ways for cordoning off Islamically suitable components within larger transactions that are otherwise non-Islamic, critics say that IF could become virtually identical to conventional finance, except for some added transaction costs. Many consider much of current practice to be mere legal artifices, combinations of transactions designed to produce indirectly a result that would be unlawful if done directly.

Critics argue that the sharia scholars lack sufficient breadth of knowledge and experience to make decisions governing the whole industry. So the question seems to be whether the process of making decisions on sharia-compliance—either in regulatory bodies or in individual financial institutions—should be widened somehow to give non-scholars an equal voice.

AP: *What are the prospects of greater convergence between conventional finance products and sharia-compliant instruments? Does integration of the*

two financial options foster broader support for IF among previously reluctant investors?

Hefner: The introduction of Islamic financial instruments into conventional banking has the potential to draw millions of otherwise hesitant Muslim investors into an economic system about which many once held reservations. By giving those who would otherwise be outside the system a stake in the system's operations, IF has the potential to improve popular welfare and significantly moderate the aspirations of political groupings that might otherwise oppose their respective government's development programs.

Akhtar: Successful application and integration of Islamic instruments with conventional financing has helped facilitate the closure of large and complex multi-source financing deals. Project financing has offered opportunities for risk diversification, avenues for resource mobilization and revenue sharing, and the performance of services between contractual parties. These deals have illustrated how conventional and Islamic financing can blend and coexist under common legal and regulatory arrangements.

AP: *Following the tragic events of September 11, 2001, perceptions of IF as a possible source of funding both for terrorist activities and for fostering Islamic radicalism still linger in the minds of U.S. investors, policymakers, and the public. How legitimate are such concerns?*

Hefner: There is no evidence that IF has ever supported movements of a terrorist nature. Indeed, rather than being an instrument of political radicalism, Islamic banking is a force for moderate social conservatism. The coalition-building required to promote IF has led most of its proponents to distance themselves from oppositional politics of any sort and instead to build support among mainstream actors in state and society.

Warde: Following September 11, Islamic banks and financial institutions provided a logical target to those who were quick to associate anything Islamic with terrorism. In a climate of general suspicion, Islamic banks—and more broadly banks from the Islamic world—were considered guilty until proven innocent. Virtually every work in the "secrets of terrorist financing" genre made such allegations. The U.S. Treasury asked foreign bank regulators, including the Saudi Arabian Monetary Authority, to place Islamic banks under close surveillance. The blow to the industry was considerable because IF had been well-integrated into the global economy and widely regarded as

a way of countering Islamic extremism. In response to perceived hostility, the effort at international coordination and standardization grew more serious and better focused.

Vogel: The experience of IF indicates that the application of sharia need not lead to extremism, rejection of Western values, or the empowerment of reactionary social groups. Initiatives under an Islamic banner can usher in improvements in Muslims' lives without engendering social, political, and international strife.

AP: *How are the U.S. policy community and corporate sector responding to the challenges and opportunities posed by developments in the IF industry?*

Venardos: There is a viable niche market for IF products in the United States. Human resources and training in IF and sharia expertise are slowly developing. Unfavorable perceptions and a lack of understanding toward Islam in general and IF in particular may, however, impede the development of IF in the United States. Changing such perceptions will take time.

Conducting IF transactions in the United States could also prove to be very difficult due to the limited pool of expertise and experience in IF among U.S. practitioners. With little exposure to IF, the average investor is unlikely to be motivated to learn the intricacies of this financial system unless he/she is aware of the huge untapped market potential.

On the other hand, there are some key U.S. banks and financial institutions offering IF products. In 2001 Freddie Mac and the American Finance House (LARIBA) began offering home financing contracts that are in accordance with Islamic law. HSBC in New York is a prominent bank offering IF products and services. Citibank is another global bank with a domestic presence offering Islamic capabilities. The establishment of the Dow Jones Islamic Indexes is yet another promising development of IF.

Key challenges facing the development of IF in the United States include: superficial understanding of the sharia factor in tailoring products and services; complying with the regulations of the Federal Reserve, Comptroller of Currency Office, and tax authorities; harmonization of the interpretation of sharia on permissible products and services; absence of sharia-trained personnel; and increased anti-Islamic sentiments in the United States since September 11. ◈